

Office of the City Auditor

Performance Audit of the City's Major Building Acquisitions Process

Presentation to the Audit Committee
July 28, 2021



Background and Audit Objectives

Objectives:

1. To determine if the City **followed policies and best practices** when purchasing buildings or entering into lease agreements worth more than \$5 million from FY2015 to FY2019; and
2. To determine if the City has **sufficient governance mechanisms for oversight** of purchases and lease agreements worth more than \$5 million from FY2015 to FY2019.



101 Ash Street Building

Background and Audit Scope

1. **Civic Center Plaza (CCP)** – Acquired in March 2015
 - Lease-to-own, 20-year term
 - Intended use: Office space
2. **101 Ash Street Building** – Acquired in January 2017
 - Lease-to-own, 20-year term
 - Intended use: Office space
3. **Kearny Mesa Repair Facility** – Acquired in May 2017
 - Lease, 15 to 30-year term
 - Intended use: Fire truck repair
4. **Palm Avenue Hotel** – Acquired in August 2017
 - Purchase
 - Intended use: Shelter for repeat misdemeanor offenders
5. **Housing Navigation Center** – Acquired in January 2018
 - Purchase
 - Intended use: Homelessness services



Civic Center Plaza Building

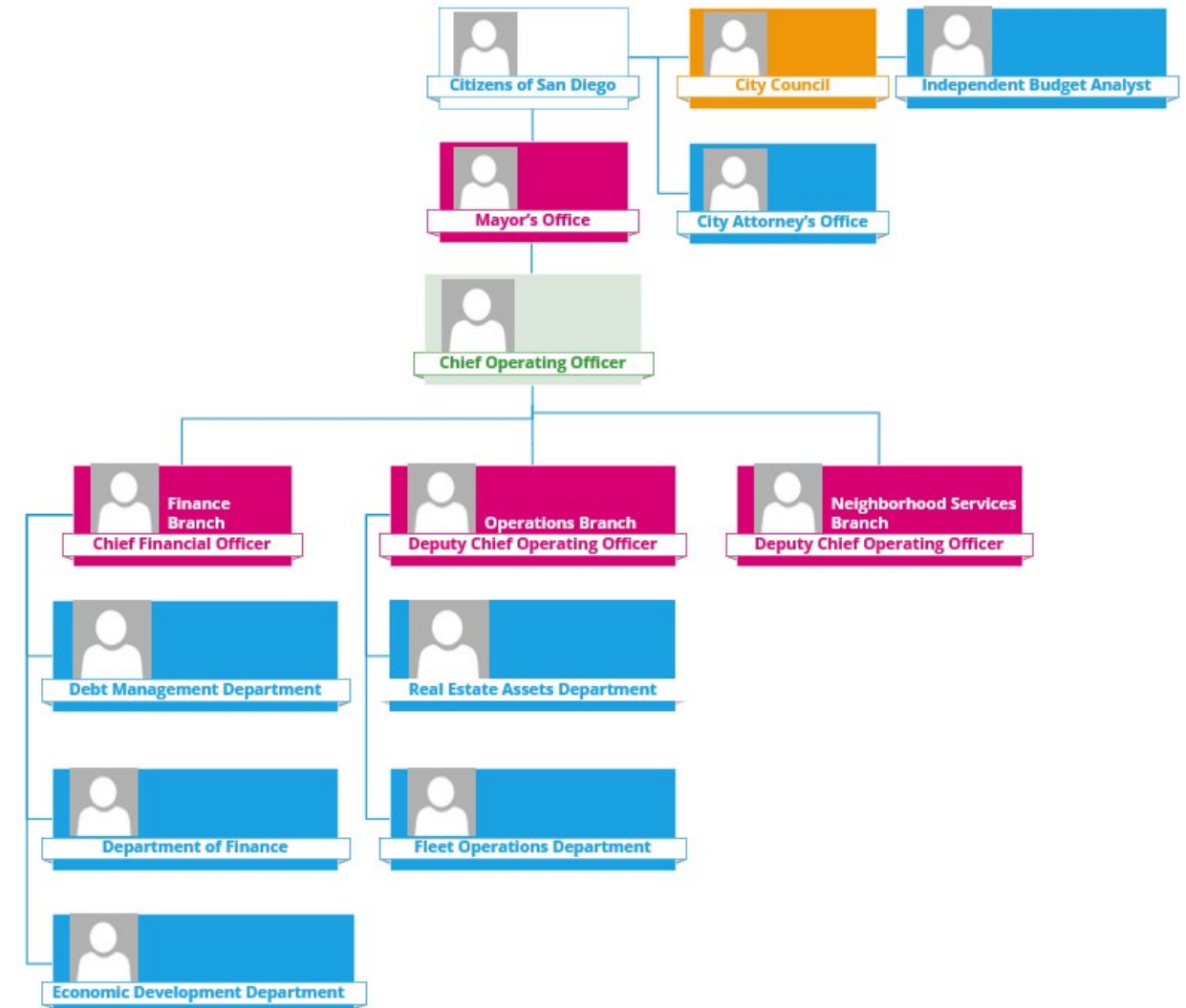
Background

Key City departments involved in the building acquisition process:

- Real Estate Assets Department
- City Attorney's Office
- Client departments

Legislative oversight:

- City Council and Council committees
- Independent Budget Analyst



Key City departments involved in the acquisition process, 2016



Finding 1 – Unclear Roles and Responsibilities

- The City **does not have a lead acquisition decisionmaker** beyond the Mayor.
- **READ believes acquiring departments are responsible** for conducting most due diligence on intended acquisitions; **acquiring departments believe due diligence is READ's responsibility.**

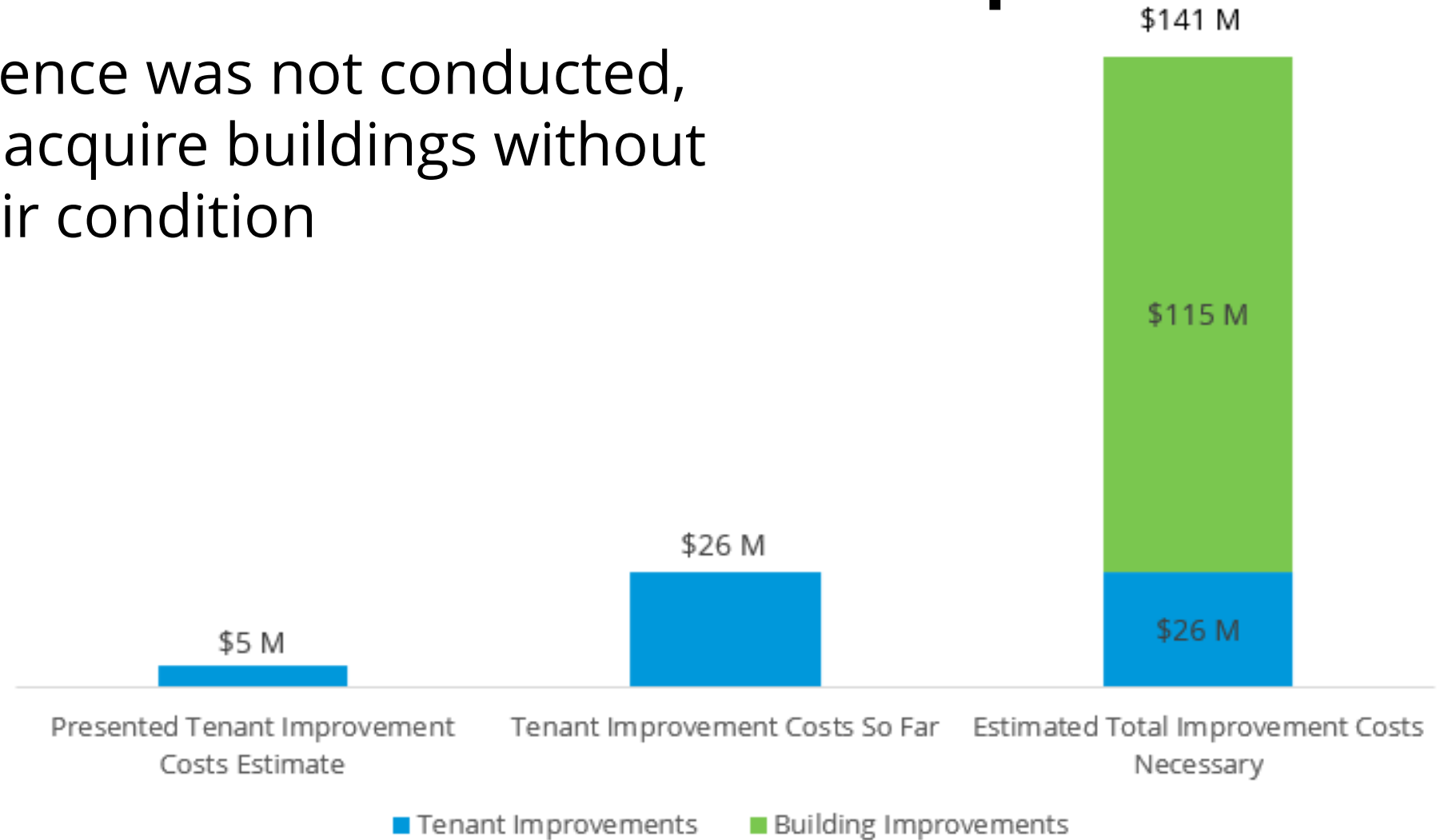


Finding 1 – Legal Risks Not Consistently Documented

- The City Attorney's Office did not consistently document the legal risks of real estate contracts to City Council.
 - On 101 Ash, the as-is clause in the contract meant the **City took on all risk of the building's condition** – placing greater emphasis on the need for sufficient due diligence.
 - The contract also states the City is “**not relying on any representation** or warranty by the Landlord with regard to the condition of the Premises,” when **the City was relying on building condition assessments provided by the seller.**

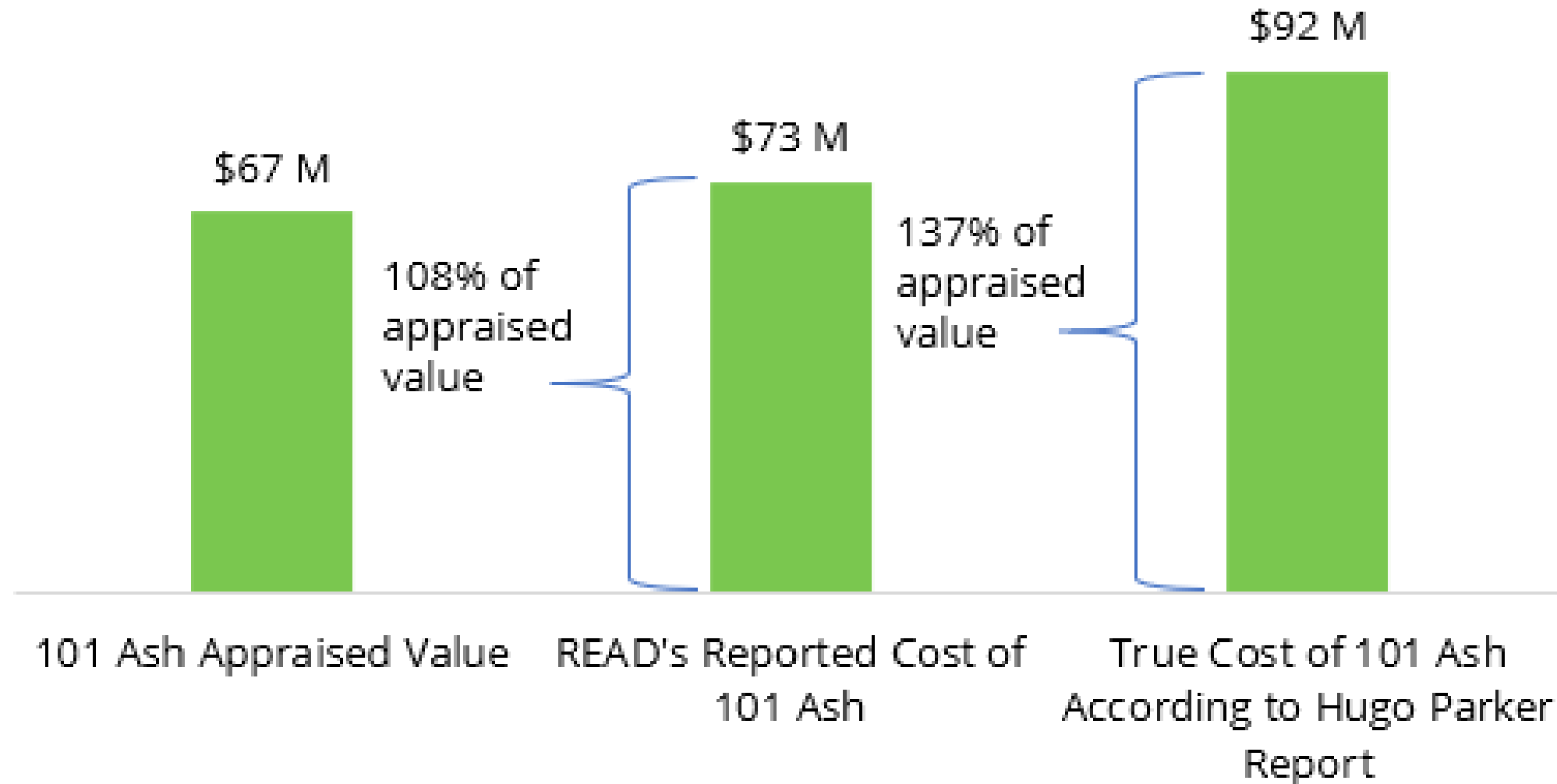
Finding 1 – Unclear Roles and Responsibilities

- Sufficient due diligence was not conducted, leading the City to acquire buildings without understanding their condition



Improvement Costs for 101 Ash are Estimated to Total \$141 Million, \$136 Million More Than Staff Presented to City Council

Finding 1 – Economic Analyses Excluded Information



READ Did Not Clearly Report the True Cost to Acquire 101 Ash



Finding 1 – Uncontracted Advisor

- The City used an **uncontracted advisor** on Civic Center Plaza and 101 Ash acquisitions.
- The advisor likely had **significant influence** in the acquisitions.
- The Mayor's Office was responsible for determining the **advisor's necessary economic disclosures**.
- The Mayor's Office did not ensure the advisor's loyalty.
- We now know the **advisor was paid \$9.4 million** for the acquisitions by the buildings' seller.



Finding 2 – Sufficient Due Diligence Not Conducted

- Due diligence ensures the acquiring entity understands the potential value and costs of its investment. Due diligence should be undertaken prior to acquisition and can include gathering independent:
 - Appraisals
 - Building condition assessments – e.g., HVAC, seismic or geological assessments, etc.
 - Asbestos inspection
 - Test fits – i.e., high-level floor plan to determine if the space will meet the intended occupants' needs.

Finding 2 – Sufficient Due Diligence Not Conducted

Building	Independent Appraisal	Independent Building Condition Assessment	Referral to Asbestos & Lead Management Program for Independent Asbestos Inspection	Test Fit
101 Ash	No	No	No	No
Civic Center Plaza	Yes	No	No	No
Housing Navigation Center	No	No	No	No
Kearny Mesa Repair Facility	No	No	No	No
Palm Avenue Hotel	Yes	No	No	No

Finding 3 – Information Not Provided to City Council

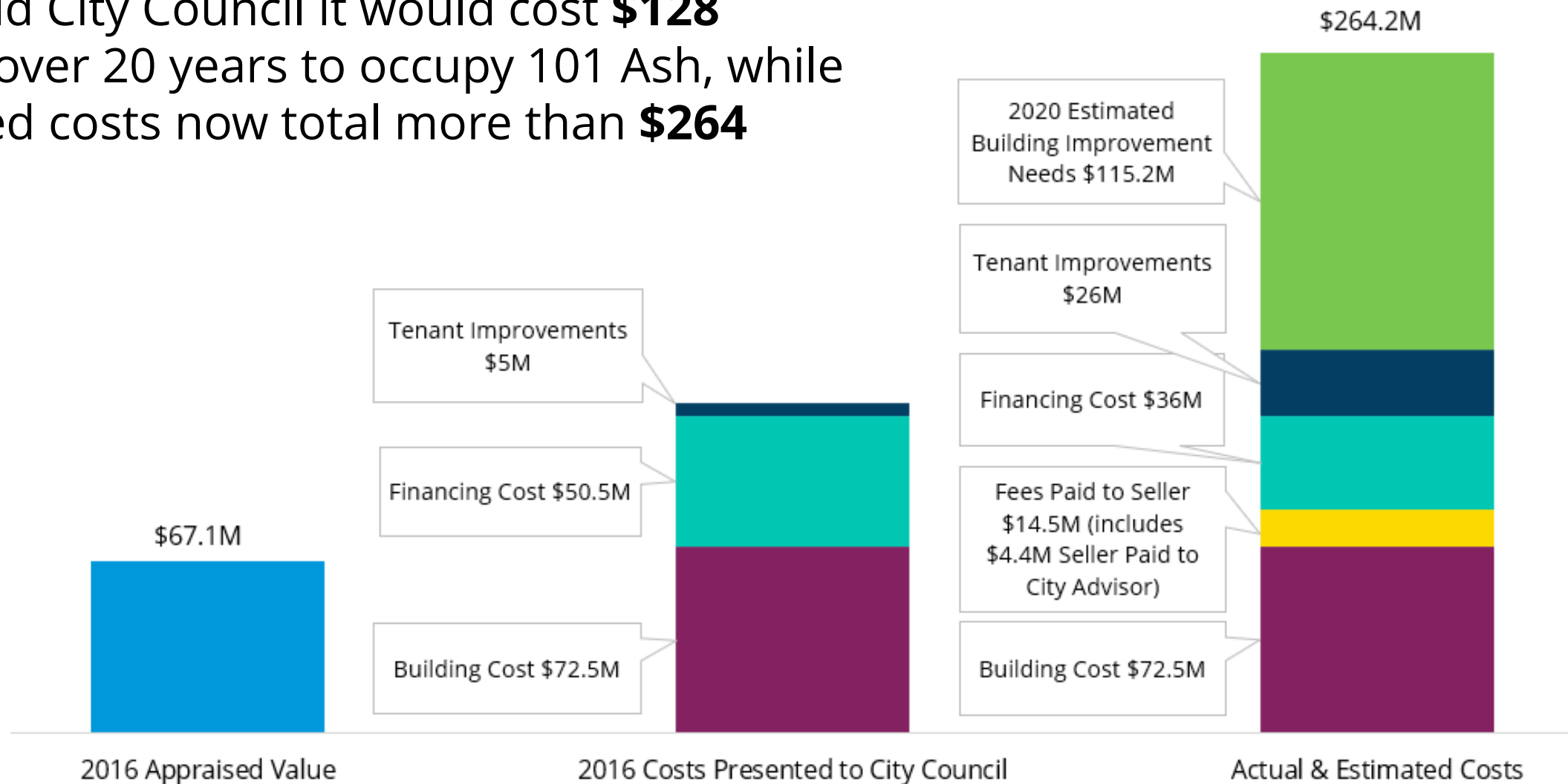
- **Misrepresented** the condition of 101 Ash
- Did not disclose the City's **incomplete understanding of 101 Ash's condition** and its lack of due diligence
- Did not disclose the **risks of the 101 Ash lease-to-own contract**
- Did not clearly state the **true cost** to purchase 101 Ash



101 Ash Street Building

Finding 3 – Information Not Provided to City Council

READ told City Council it would cost **\$128 million** over 20 years to occupy 101 Ash, while estimated costs now total more than **\$264 million**.



Finding 3 – Information Not Provided to City Council

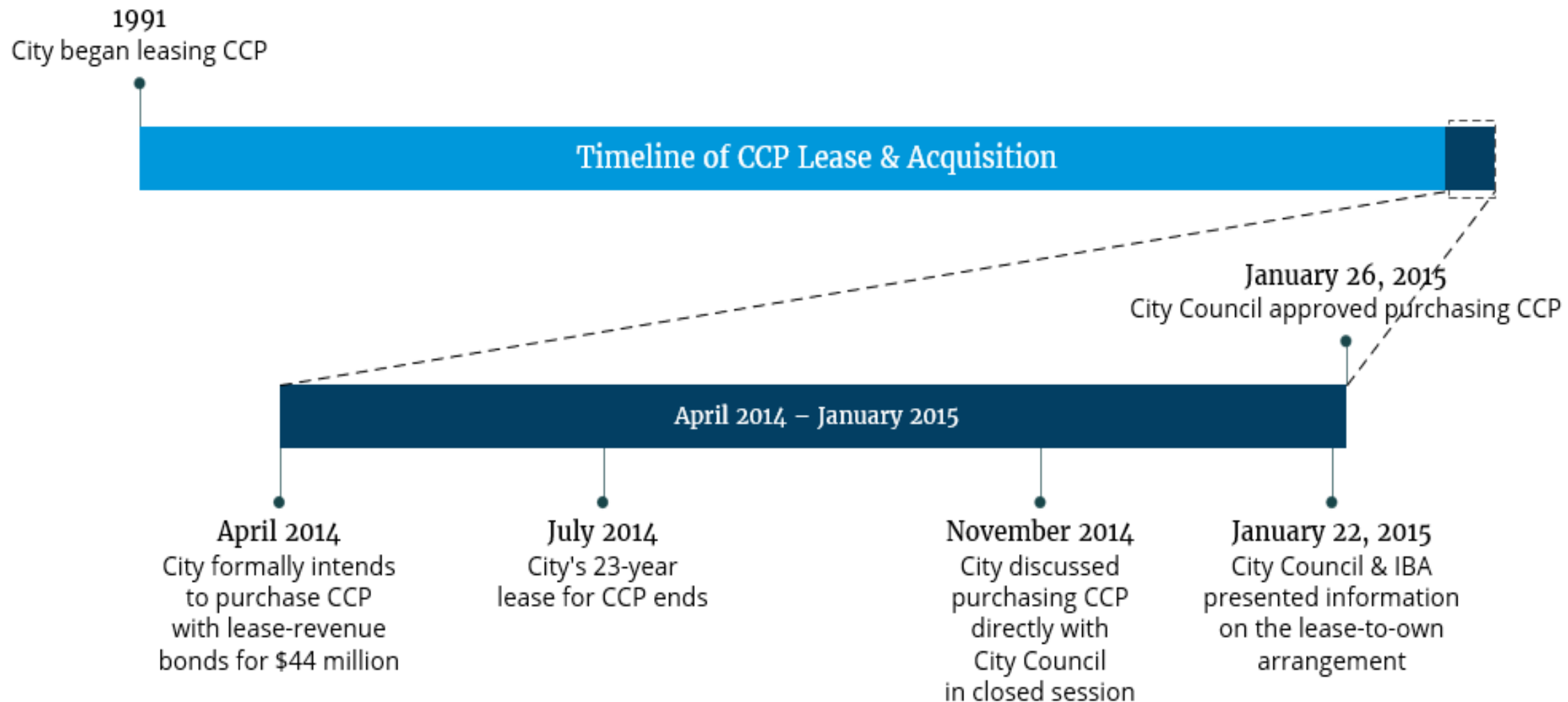
Inflated value of the skydiving center

- Staff told Council that the building was worth **\$15-22 million** and led them to believe it was a great deal at \$7 million
- However, the building was appraised based on its **potential income as a skydiving center**, not the City's intended use
- A later appraisal confirmed the building's value at \$7.2 million



Housing Navigation Center

Finding 3 – Rushed Timeframes Minimize Council Review





Recommendations

We made 10 recommendations. Key recommendations include:

- Requiring a **best practices checklist** for building acquisitions.
- Establishing **clear roles and responsibilities** for City departments.
- Developing and using a **strategic real estate plan**.
- Requiring all contractors or advisors on real estate transactions have a **signed contract** with the City.
- Requiring READ to create a **due diligence checklist**.
- Adding a section to the municipal code to provide an **enforcement mechanism** to ensure City staff accurately represent information to City Council.
- Providing the Office of the Independent Budget Analyst with **sufficient time and information** to review the Mayor's major building acquisition proposals.



Recommendations

The **City Administration did not agree** to fully implement most of our recommendations. Specific areas of disagreement include:

- **Requiring** the checklists;
 - We appreciate that the City Administration has now agreed to implement Recommendation 1; however, it is unclear if they agree to fully implement Recommendation 5 and the following recommendations.
- **Informing the Independent Budget Analyst** of forthcoming acquisitions prior to beginning negotiations;
- Confirming contractors have contracts with the City and have **filed proper economic disclosures**; and
- Obtaining an independent **appraisal before agreeing on purchase price.**



Recommendations – City Attorney’s Office and Independent Budget Analyst

We made two recommendations to the IBA:

- Directing the IBA, in consultation with the City Attorney’s Office, propose to City Council a section to add to the municipal code to provide an **enforcement mechanism** to ensure City staff accurately represent information to City Council.
- Recommending the IBA consider requesting budget approval for an **as-needed consultant** for assistance in reviewing the best practices checklist.

The **IBA agreed** to implement our recommendations.



Recommendations – City Attorney’s Office and Independent Budget Analyst

The **City Attorney’s Office did not agree** to assist the IBA to implement our recommendation:

- Adding a section to the municipal code to provide an **enforcement mechanism** to ensure City staff accurately represent information to City Council.

Conclusion

We ask the Audit Committee to accept and forward the audit report to the City Council.